

1 KAREN A. OVERSTREET
Bankruptcy Judge
2 United States Courthouse
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4

5 UNITED STATES BANKRUPTCY COURT
6 WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

7 In re)
8 CASCADIA PROJECT LLC,) Chapter 7
9) Bankruptcy No. 09-20780
Debtor.)
10) **MEMORANDUM DECISION**
11) **NOT FOR PUBLICATION**

12 This matter came before the Court on March 18, 2011, on the
13 Final Application for Compensation and Reimbursement of Expenses
14 (the "Application"), filed by Obsidian Finance Group, LLC
15 ("Obsidian"), the financial advisor to the debtor, Cascadia Project
16 LLC (the "Debtor"). Dkt. 634. HomeStreet Bank ("HomeStreet"), the
17 Debtor's largest secured creditor, filed the only objection to the
18 Application.¹ At a hearing on the Application on March 18, 2011,
19 the Court invited the parties to file additional pleadings
20 addressing whether Obsidian had a conflict of interest which might
21 mandate disallowance of all or part of the fees sought. Obsidian
22 and HomeStreet filed supplemental briefs and declarations, which
23 the Court has considered, in addition to the initial pleadings
24 filed in support of and in opposition to the Application. See Dkt.
25

26
27 ¹ At the hearing, the Court made an orally ruled that
28 HomeStreet has standing to oppose the Application. The oral ruling
is incorporated in this Memorandum Decision by this reference.

1 655, 656, 657, 658.

2 For the following reasons, the Court finds that Obsidian had a
3 conflict of interest as of May 17, 2010, when it agreed to acquire
4 an ownership interest in the Debtor, and that its fees and costs
5 incurred on and after that date should be denied.

6 **I. FACTS**

7 The Debtor filed its voluntary petition for relief under
8 Chapter 11 of the United States Bankruptcy Code² on October 15,
9 2009. On December 4, 2009, the Debtor submitted an application for
10 authorization to employ Obsidian as its financial advisor. As set
11 forth in the Application and the Declaration of Kevin Padrick,
12 senior principal and co-founder of Obsidian, Obsidian did not hold
13 an adverse interest to the estate, and it was considered a
14 disinterested person under Bankruptcy Code § 327(a).³ Application
15 to Employ, Dkt. 91; and Declaration of Kevin Padrick, Dkt. 92. On
16 January 28, 2010, the Court entered an order approving the
17 employment of Obsidian as a financial advisor. Dkt. 188. Pursuant
18 to the order, Obsidian was appointed "to perform all services
19 necessary to effectively assist and advise the Debtor with regard
20 to financial issues and other matters set forth in the Application
21 or as may otherwise become necessary." *Id.* at ¶2. Further, the
22

23 ² Unless otherwise indicated, all Code, Chapter, Section and
24 Rule references are to the Bankruptcy Code, 11 U.S.C. §§101 *et seq.*
25 and to the Federal Rules of Bankruptcy Procedure, Rules 1001 *et*
seq.

26 ³ The Application to Employ disclosed that Kevin Padrick was
27 a former partner of Miller Nash, counsel representing the Debtor.
28 Thus, counsel for the Official Committee of Unsecured Creditors
(the "Committee") in this case has filed various pleadings,
including the Application, on behalf of Obsidian.

1 order approved an alternative form of compensation, whereby
2 Obsidian would discount its hourly rates charged to the bankruptcy
3 estate by 50% in exchange for a success fee to be paid after
4 confirmation that would be equal to three times the total amount of
5 its 50% hourly rate reduction. *Id.*

6 On February 9, 2010, the Committee filed a Supplemental
7 Declaration of Kevin Padrick, whereby it was disclosed that
8 Obsidian engaged the law firm of Ball Janik LLP, counsel for
9 HomeStreet, the major secured creditor in the case, as its counsel
10 on matters unrelated to the bankruptcy case. First Supplemental
11 Declaration of Kevin Padrick, Dkt. 201. On March 23, 2010, the
12 Court entered an order awarding Obsidian compensation for services
13 in the amount of \$131,774 and reimbursement of expenses in the
14 amount of \$4,837.79. Dkt. 240. Of the amount awarded, \$66,399.24
15 remains unpaid.

16 The Debtor filed its Chapter 11 Plan of Reorganization (the
17 "Plan") and Disclosure Statement on May 31, 2010. Dkt. 333, 334.
18 Attached to the Plan was a Letter of Intent for Acquisition and
19 Funding of the Cascadia Project LLC ("LOI") dated May 28, 2010,
20 among TPG Opportunities Partners, L.P. ("TPG"), Yarrow Bay Holdings
21 ("Yarrow Bay"), and Obsidian. According to the LOI, TPG, Yarrow
22 Bay, and Obsidian were to acquire 100% of the equity interest in
23 the Debtor and to jointly contribute up to \$55 million to fund the
24 Plan. Obsidian's proposed contribution under the LOI was 2% of the
25 total investment, equating to \$1.1 million. Additionally, the
26 acquisition of the Debtor's equity interest was to be accomplished
27 through a newly formed limited liability company owned by the three
28 investors. Section 3 of the LOI provided that the reorganized

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1 debtor would be managed by a newly created servicing entity owned
2 60% by Yarrow Bay and 40% by Obsidian (the "Servicing Entity").
3 The Servicing Entity would provide day-to-day servicing of the
4 project in exchange for a monthly fee of \$75,000 plus bonuses.
5 Dkt. 333, Exhibit 1.⁴

6 On June 14, 2010, HomeStreet filed a Motion to Disqualify
7 Obsidian as the Debtor's financial advisor on the ground that
8 Obsidian's status as an investor in the reorganized debtor under
9 the Plan created a conflict of interest rendering Obsidian
10 disinterested under Section 327(a) (the "Motion to Disqualify").
11 Dkt. 400. Three days later, on June 17, 2010, Mr. Padrick filed a
12 Second Supplemental Declaration regarding Disclosure of Connections
13 by Obsidian, disclosing Obsidian's role under the LOI. Dkt. 426.
14 Specifically, the declaration disclosed that Obsidian would be an
15 investor under the Plan and be a servicer for the ongoing
16 operations of the reorganized debtor. *Id.*

17 At the evidentiary hearing on HomeStreet's Motion for Relief
18 from Stay (the "Evidentiary Hearing"), held June 22 through 24 of
19 2010, Mr. Padrick testified extensively. Over hours of
20 questioning, he took the Court and the parties through the
21 complicated and detailed business model constructed by Obsidian for
22 the development of the Cascadia planned community. He testified
23 that Cascadia's 4,400 acre parcel would ultimately be developed
24 into one of the largest employment-based, planned communities in

25
26 ⁴ On June 19, 2010, the Debtor filed its First Amended
27 Chapter 11 Plan of Reorganization, attached to which was the LOI.
28 Dkt. 445. The amended plan was in substance no different than the
Plan as the terms related to the transactions at issue here,
accordingly, the Court will refer hereinafter only to the Plan.

1 the State of Washington and that it would include the development
2 of residential, commercial, business and educational properties in
3 conjunction with the development of an adjacent property as a golf
4 course and resort community consisting of 514 acres. Mr. Padrick
5 testified that the project contemplated as many as 40,000 people
6 living and/or working in the Cascadia community. The development
7 model was dependent upon the funding to be provided by the
8 investors, including Obsidian, under the LOI.

9 On the first day of the Evidentiary Hearing, Mr. Padrick
10 testified that at a meeting with representatives of TPG on May 17,
11 2010, TPG made it a condition of any investment in the Debtor by
12 TPG that Obsidian also participate as an investor. Prior to this
13 meeting, according to Mr. Padrick's testimony, Obsidian had no
14 intention to act as an investor under the Plan. Mr. Padrick
15 further testified that pursuant to the LOI and the Plan, if
16 confirmed and performed, Obsidian would realize approximately \$28
17 million on its \$1.1 million investment in the reorganized debtor.
18 Mr. Padrick testified that after the May 17, 2010 meeting with TPG,
19 he consulted with the Debtor's counsel and the Committee's counsel
20 before committing Obsidian to be an additional investor in the
21 Debtor and owner of the Servicing Entity under the LOI.

22 At the conclusion of the Evidentiary Hearing, the Court found
23 that the Debtor had proved it had a reasonable possibility of
24 confirming the Plan within a reasonable time and that HomeStreet's
25 motion for relief from stay should be denied. The Court's
26 conclusion required an examination of the feasibility of Obsidian's
27 development model and was based largely on the substantial
28 testimony provided by Mr. Padrick in support of the Plan and the

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1 development model. The Court's decision to deny relief from stay
2 even though the LOI was contingent at the time of the Evidentiary
3 Hearing was based almost entirely on Mr. Padrick's opinion that
4 there was a "70% likelihood" that TPG would enter into binding
5 agreements incorporating the then contingent terms of the LOI.

6 The hearing on HomeStreet's objection to Obsidian's continued
7 service as the Debtor's financial advisor was not scheduled to be
8 heard until after the conclusion of the Evidentiary Hearing, which
9 concluded on June 24, 2010, with the Court's oral ruling.

10 Accordingly, the Court made no findings in connection with the
11 Evidentiary Hearing concerning whether a conflict had arisen with
12 respect to Obsidian's service as the Debtor's financial advisor.
13 Unfortunately for the Debtor, TPG ultimately declined to enter into
14 binding agreements with the Debtor, Yarrow Bay and Obsidian, and
15 HomeStreet renewed its motion for relief from stay on August 1,
16 2010. Dkt. 528. According to the Debtor's response to
17 HomeStreet's renewed motion, TPG was willing to commit to only 50%
18 of its proposed investment under the LOI, which was \$49.5 million
19 (90% of the total of \$55 million). The Debtor's response, which
20 was supported by the Declaration of Kevin Padrick, requested the
21 Court to grant Obsidian additional time to find another investor to
22 make up the difference in funding. Dkt. 540. By the time of the
23 hearing on HomeStreet's renewed motion for relief from stay on
24 August 6, 2010, the Debtor had not secured an additional investor
25 and the Court granted HomeStreet's motion that same day. Dkt. 545.

26 At the time HomeStreet filed the Motion to Disqualify, it also
27 filed a motion to shorten the time for a hearing, requesting that
28 the motion be heard on June 16, 2010, before the commencement of

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1 the Evidentiary Hearing. Dkt. 396. The Debtor objected to
2 shortening the time for hearing on the Motion to Disqualify (Dkt.
3 406), and the Court conducted a special hearing on June 16, 2010.
4 After considering the arguments of all parties, the Court declined
5 to shorten the time for hearing on the Motion to Disqualify and
6 instead ordered that the hearing be continued to July 23, 2010.
7 The Court indicated that if Obsidian, which had just obtained
8 separate counsel, wanted the Motion to Disqualify to be heard
9 before July 23, Mr. Padrick could agree to that and set it on the
10 calendar with the concurrence of HomeStreet.

11 No request to hear the Motion to Disqualify prior to July 23,
12 2010, was ever made by Obsidian. Instead, at a status conference
13 held on July 16, 2010, in anticipation of a settlement between
14 HomeStreet and the Debtor (with funding by TPG), the parties asked
15 to continue the hearing on the Motion to Disqualify to August 27,
16 2010. After TPG declined to go forward again and the Court granted
17 HomeStreet's motion for relief from stay on August 6, 2010,
18 however, HomeStreet struck the hearing on the Motion to Disqualify.

19 The Application seeks compensation for services and
20 reimbursement of fees and expenses incurred by Obsidian as the
21 Debtor's financial advisor from February 1, 2010 through
22 September 22, 2010 in the amount of \$673,174.26. HomeStreet
23 objected to the Application and argues that Obsidian acquired an
24 interest adverse to the Debtor's estate mandating the Court's
25 disallowance of all fees and costs requested.

26 **II. DISCUSSION**

27 Bankruptcy Code §330(a), in relevant part, provides that the
28 court may award a professional person employed under Section 327 or

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1 Section 1103 reasonable compensation for actual, necessary services
2 rendered and reimbursement for actual, necessary expenses incurred.
3 Section 328(c) permits the court to deny allowance of compensation
4 for services and reimbursement of expenses of a professional person
5 if, at any time during the professional's employment, they are not
6 a "disinterested person," or represent or hold an interest adverse
7 to the interest of the estate with respect to the matter on which
8 they have been employed.

9 Under §327(a), the court-appointed professional must be
10 "disinterested," and must not represent or hold any interest
11 adverse to the estate. The term "disinterested" is defined under
12 Section 101(14) to mean a person who "is not a creditor, an equity
13 security holder, or an insider" and who "does not have an interest
14 materially adverse to the interest of the estate or of any class of
15 creditors or equity security holders, by reason of any direct or
16 indirect relationship to, connection with, or interest in, the
17 debtor, or for any other reason." In the Ninth Circuit, the test
18 for determining whether a professional has an interest that is
19 materially adverse to the estate so as to not qualify as
20 disinterested requires an objective, fact-driven inquiry into the
21 totality of circumstances. *In re AFI Holding, Inc.*, 530 F.3d 832
22 (9th Cir. 2008). The term "disinterested" is broad enough to
23 disqualify anyone from being employed as a professional who might
24 have the slightest degree of interest or relationship that "would
25 even faintly color the independence and impartial attitude required
26 by the Code." *Id.* at 838, *quoting In re AFI Holding, Inc.*, 355
27 B.R. 139 (9th Cir. BAP 2006). The phrase "hold or represent an
28 interest adverse to the estate" is not defined in the Code, but has

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1 been interpreted by courts to mean (1) to possess or assert any
2 economic interest that would tend to lessen the value of the
3 bankruptcy estate or that would create either an actual or
4 potential dispute in which the estate is a rival claimant, or
5 (2) to possess a predisposition under circumstances that render
6 such a bias against the estate. *In re Crivello*, 134 F.3d 831, 835
7 (7th Cir.1998). The statutory requirements of disinterestedness
8 and lack of adverse interest serve the important policy of ensuring
9 that all professionals appointed pursuant to the Code serve the
10 estate with undivided loyalty and provide untainted advice and
11 assistance in furtherance of their fiduciary responsibilities. *Id.*
12 at 835-36.

13 In this case, Obsidian was employed as the Debtor's financial
14 advisor, and the services to be provided were broad. It was
15 contemplated that Obsidian would provide not only financial advice,
16 but would also develop strategies for reorganization and work with
17 creditors and potential investors to raise equity to fund the plan
18 of reorganization. Because the Debtor is a single asset real
19 estate debtor, it was under immense pressure to propose a plan
20 within an expedited period of time. The aggressive, but entirely
21 lawful, actions by HomeStreet as the Debtor's major secured
22 creditor to enforce its rights limited the time and ability of the
23 Debtor to develop reorganization alternatives. Obsidian embarked
24 upon the preparation of a complicated and detailed business model
25 for development of the project that could be marketed to potential
26 investors. Having constructed that model, Obsidian was intimately
27 familiar with the risks associated with any investment in the
28 reorganized debtor. The investment Obsidian ultimately agreed to

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1 make under the LOI was substantial.

2 Obsidian contends that its agreement to invest in the
3 reorganized debtor did not create an interest materially adverse to
4 the estate and thereafter it could remain disinterested, despite
5 it's new role as an investor, because it agreed to subordinate any
6 return on its investment or profit to the full payment of all
7 creditors of the estate. It argues that even as an investor,
8 Obsidian's interests were fully aligned with the interests of the
9 estate, each with the goal of maximizing the return to creditors.
10 HomeStreet counters that Obsidian's assumption of the role of buyer
11 of estate assets created a direct conflict of interest, and its
12 agreement to subordinate payment of its financial return to the
13 payment of creditors is irrelevant.

14 The Court agrees with HomeStreet that under the circumstances
15 of this case, Obsidian's dual role as investor and financial
16 advisor went beyond a mere hypothetical conflict and instead gave
17 rise to an actual and material conflict with the interests of the
18 estate. That conflict was not eliminated or even ameliorated by
19 Obsidian's agreement to subordinate the return on its investment to
20 payment to creditors. As the Debtor's financial advisor, Obsidian
21 could realize its success fee under its employment agreement only
22 if a reorganization plan was confirmed. If the Plan had been
23 confirmed, that success fee would have approximated \$2 million. If
24 the Plan had been confirmed and was fully performed, Obsidian would
25 realize, in addition to its success fee and its administrative
26 expense claim for compensation and expenses, an estimated \$28
27 million return on its equity investment in the Debtor. Once tied
28 to TPG under the LOI, Obsidian was bound to pursue that option to

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1 the exclusion of other options that might have been available to
2 the Debtor. Mr. Padrick testified at the Evidentiary Hearing and
3 argues here that TPG was the Debtor's only option. Given
4 Obsidian's conflict, however, the Court finds Obsidian's
5 "independence and impartial attitude required by the Code" more
6 than faintly compromised on and after May 17, 2010.

7 The cases cited by Obsidian in support of its contention that
8 the seller-buyer role does not give rise to an actual conflict
9 under the facts of this case are not persuasive. Instead, the
10 Court is persuaded by the analysis of the Fifth Circuit Court of
11 Appeals in *In re West Delta Oil Co., Inc.*, 432 F.3d 347 (5th Cir.
12 2005). In that case, the court held that an attorney who
13 represented the debtor could not seek to acquire a financial
14 interest in the entity proposing to acquire the debtor. Under the
15 facts of that case, unlike this case, the attorney never signed an
16 agreement to acquire that interest. The court there noted "[w]hile
17 they [the professionals] failed in their effort to acquire an
18 interest in West Delta [the debtor], this failure was not for lack
19 of effort" and it concluded that the bankruptcy court's
20 determination that the professionals' interest was contingent
21 ignored "the reality that both [professionals] testified to taking
22 affirmative steps in an effort to acquire a valuable financial
23 stake in their client. The ultimate success of these efforts is
24 irrelevant-the active pursuit of success is sufficient to give rise
25 to an adverse interest here." *Id.* at 357.

26 In this case, not only did Obsidian sign the LOI obligating it
27 to acquire an ownership interest in the reorganized debtor, it was
28 at the same time negotiating the terms of the arrangement between

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1 the Debtor and TPG. From May 17, 2010, when Obsidian agreed to
2 become an investor, until May 31, 2010, when the Debtor filed the
3 Plan and disclosed the interest of Obsidian in the LOI, Obsidian
4 was negotiating the return on its investment, its share of the
5 servicing fee, and its interest in the Servicing Entity, all on *its*
6 *own behalf*. This clearly gave rise to a conflict with regard to
7 its simultaneous negotiation of the terms of the LOI as it would
8 affect the Debtor and the creditors of the estate. Evidence of
9 actual prejudice to the estate is irrelevant, because it is
10 difficult to prove and because the problem is not just "actual evil
11 results" but also the "tendency to evil." *Woods v. City of Nat'l*
12 *Bank & Trust Co.*, 312 U.S. 262, 268 (1941). Under the facts of
13 this case, given Obsidian's conflict, the Court must deny
14 compensation to Obsidian for the period during which it had an
15 actual conflict of interest.

16 That counsel for the Debtor and for the Committee acquiesced
17 in Obsidian's dual role does not negate the requirements of
18 Sections 327(a), 328(c), and 101(14). Similarly, the fact that the
19 Court did not intervene *sua sponte* and issue an order to preclude
20 further work by Obsidian does not save Obsidian from denial of
21 compensation. Obsidian and Mr. Padrick are sophisticated parties
22 who specialize in transactions involving distressed companies and
23 properties. They are fully aware of the statutory requirements of
24 the Code and as far as the Court is concerned are fully capable of
25 determining when they want to abandon their role as an estate
26 advisor in favor of a potentially lucrative role as an estate
27 investor. If Obsidian desired a ruling from the Court it could
28 have objected to the Motion to Disqualify and brought the matter to

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1 the Court for hearing. Instead, Obsidian either acquiesced in or
2 encouraged HomeStreet to withdraw the motion after the Court
3 granted HomeStreet's motion for relief from stay.

4 Obsidian contends that its full disclosure of its involvement
5 in the Plan somehow rids it of the conflict of interest. Rule
6 2014(a) requires any professional applying for employment to set
7 forth "to the best of the applicant's knowledge" all known
8 connections of the applicant with the "debtor, creditors, or any
9 other party in interest, their respective attorneys and
10 accountants, the United States trustee, or any person employed in
11 the office of the United States trustee." While this provision
12 does not explicitly require ongoing disclosure, case law has
13 uniformly held that under Rule 2014(a), (1) full disclosure is a
14 continuing responsibility, and (2) a professional is under a duty
15 to promptly notify the court if any potential for conflict arises.
16 See *In re Metropolitan Environmental, Inc.*, 293 B.R. 871, 887
17 (Bankr.N.D.Ohio 2003). See also *In re West Delta Oil Co., Inc.*,
18 *supra*. A professional's failure to fully disclose relevant
19 information as required under the Bankruptcy Code and Rules may
20 result in denial of all requested compensation for a professional
21 fee applicant. *In re Park-Helena Corp.*, 63 F.3d 877, 881 (9th Cir.
22 1995).

23 In this case, Obsidian failed to disclose it's conflict under
24 Rule 2014 immediately when it arose on May 17, 2010. Instead, the
25 conflict was not disclosed until after HomeStreet filed its Motion
26 to Disqualify on June 14, 2010. By that time, Obsidian had been
27 acting simultaneously as the estate's financial advisor and as a
28 proposed investor in the Debtor for a month and the path to the

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1 Debtor's reorganization was fixed with TPG for purposes of the
2 upcoming Evidentiary Hearing. Accordingly, the Court finds that
3 Obsidian's belated disclosure does not absolve it of the
4 consequences of the conflict of interest.

5 The Court has considerable discretion in fashioning a remedy
6 under the circumstances of this case, including the denial of all
7 fees and costs requested by Obsidian. See *In re Ponce Marine Farm,*
8 *Inc.*, 259 B.R. 484 (D. Puerto Rico 2001). The Court finds,
9 however, based upon the uncontroverted testimony of Mr. Padrick,
10 that prior to May 17, 2010, Obsidian was a disinterested
11 professional acting in the interest of the estate. Thus, the Court
12 concludes that denial of all fees and costs incurred by Obsidian is
13 not warranted.

14 CONCLUSION

15 For the foregoing reasons, the Court finds that as of May 17,
16 2010, Obsidian had an actual conflict of interest with the
17 interests of the estate and that compensation and expenses incurred
18 on and after that date must be denied. Obsidian shall calculate
19 the amount of the fees to be disallowed pursuant to this Memorandum
20 Decision and submit an order consistent with this Memorandum
21 Decision.

22 //END OF MEMORANDUM DECISION//
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24

25 
26 United States Bankruptcy Judge
27 (Dated as of Entered on Docket date above)
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